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C O N F I D E N T I A L SECTION 01 OF 02 DHAKA 000906

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SUBJECT: CONTINUED INFLATION LEAVES PUBLIC SIMMERING

Classified By: Acting Deputy Chief of Mission Dundas McCullough;
reason 1.4(d)

11. (C) Summary: The military-backed caretaker government continues to face popular discontent over price rises, especially for basic food commodities. Recent press reports highlight public concerns as did the Centre for Policy Dialogue in a June 2 public presentation on the state of the Bangladesh economy. Respondents to the Third National Public Perception Study Report sponsored by the Election Working Group in cooperation with The Asia Foundation remain concerned about price increases and believe economic activity has slowed. These concerns are not new; inflation at the end of the BNP government threatened to become a major election issue. The CTG's inability to satisfy (unrealistic) public expectations for a quick solution, however, contributes to growing public concern over the performance of the government. End Summary.

12. (C) The overall inflation rate for FY 06 (ended June 30) was seven percent and the rate is projected to remain near seven percent for FY 07. Rampant corruption during the BNP led government contributed to the popular belief that hoarding and anti-competitive behavior by "syndicates" were largely to blame. Responding to popular sentiment, the government moved swiftly to arrest "hoarders" and seize warehouses in several highly publicized raids. Not surprisingly, the raids created spot shortages and had little effect on overall prices. Backtracking, the government announced it would adopt regulations on "hoarding" to provide certainty to the business community; however, new rules have yet to be issued. The continuing uncertainty has had a chilling effect, with business leaders telling us they are unwilling to import in the most economical bulk quantities.

13. (C) In fact, recent economic studies attribute inflation trends to a number of interrelated factors, many of which are rooted in structural problems in the economy. Ironically, reforms undertaken by the government have actually exacerbated price pressures in the short term, although the long-term impact should be more favorable for growth.

14. (C) Rising international energy prices are a key factor. Both the BNP and the government were forced to raise electricity and fuel prices, which the government subsidizes through below-market pricing by the state-owned energy corporations. (Note: The IMF urges further increases to remove distortions in the energy market and to reduce the fiscal burden of the subsidies. End Note.) These costs have rippled through the economy, particularly in the transportation sector. Agriculture is especially vulnerable. Electric and diesel pumps are used to irrigate rice fields,

while transportation costs are a significant component of agricultural prices, especially in the major urban areas.

15. (C) Tight international commodity prices are also a factor. Bangladesh produces most of the rice it consumes and crop yields this year were comparable to previous years. High international prices and growing demand in India, however, have reduced pressure on domestic prices from previously cheap rice imports. Bangladesh relies on imports for several other key food commodities, including oilseeds, pils, and lentils and rising international prices have increased domestic prices. Bangladeshis have traditionally substituted lower cost domestic wheat for rice when rice prices rose, decreasing demand for rice; however, high international wheat prices have kept domestic prices high as well. Increasing international prices for non-food imported commodities, such as steel, also contribute to domestic price pressures.

16. (C) Chronic structural problems are also contributing to inflation. A severe (40%) shortfall in electricity generation prevents factories from operating at full capacity and forces many businesses and farms to run high-cost diesel generators to supplement the power supply. To reduce peak demand, the government ordered businesses to close at 7 pm (versus 10-11 pm), limiting commercial activity during traditionally high-volume business hours. According to the TAF study, many people believe economic activity has slowed as a result of the early closings. Weak transportation infrastructure also undermines productivity and raises production costs. Operations at Chittagong Port are a key exception. Privatization of port operations and the absence of disruptions from nationwide strikes has significantly enhanced the efficiency of the port and reduced port-related

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costs.

17. (C) Government programs to address core governance concerns, especially corruption and tax evasion, have created short-term disruptions that are impacting the economy. The high profile anti-corruption campaign and district-level anti-crime task forces reportedly have sent many middle-level businessmen with notorious reputations for corruption into hiding, disrupting existing distribution channels. The government's reliance on evidence of significant financial transactions as "probable cause" to investigate individuals and businesses for possible corruption, tax evasion or anti-competitive behavior (hoarding) has reportedly created commercial uncertainty and chilled economic activity. Anecdotal, businessmen report they are importing smaller quantities of goods and delaying significant investments so as not to call attention to their activities.

18. (C) Despite these concerns, GDP growth for FY 07 is projected to be around 6.3%, down only slightly from the 6.7% figure for FY 06. Much of the decline is attributable to economic disruptions from civil unrest in the second quarter.

While the government has undertaken some steps to support the economy -- reducing import tariffs on food commodities, for example, and addressing immediate issues at Chittagong Port -- its real impact will be felt in FY 08, starting with the fiscal and economic policies embedded in its first budget, due to be released later this month. It is the performance of the economy in FY 08, more than anything else, that will shape popular perception of -- and support for -- the government's economic performance.

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